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BEFORE THE ARIZONA CORPORATION COMMISSION

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Commissioner
JEFF HATCH-MILLER
Commissioner
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Commissioner

IN THE MATTER OF QWEST CORPORATION'S FILING AMENDED RENEWED PRICE REGULATION PLAN

DOCKET NO. T-01051B-03-0454

NOTICE OF FILING AMENDED RENEWED PRICE REGULATION PLAN

Pursuant to Arizona Corporation Commission ("Commission") Decision No. 63487, Qwest Corporation ("Qwest") files the Qwest Renewed Price Regulation Plan in accordance with the provisions of the Second Revised Settlement Agreement approved on March 30, 2001.

Qwest is not filing Attachments with the Amended Price Regulation Plan because there are no amendments to the Attachments.

RESPECTFULLY SUBMITTED this 26 day of September, 2003.

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QWEST RENEWED PRICE REGULATION PLAN

ARIZONA

1. BACKGROUND

In 2001, the Arizona Corporation Commission ("ACC" or "Commission") adopted a Price Regulation Plan for Qwest. This plan was the result of a stipulation between Staff and Qwest which was subsequently modified by the Commission. The adoption of this price regulation plan was an important first step by the Commission to move away from traditional utility-style regulation. That plan provided for Qwest to request renewal "under the current terms and conditions" or to request renewal with revisions. Qwest is filing this notice to request renewal with revisions. Qwest is proposing to continue the evolution of price regulation in Arizona to reflect both competitive realities and the need for greater pricing and packaging flexibility. The revisions Qwest is seeking also give the Company greater assurance of an opportunity to recover the fair value of its assets as competition with all of its service offerings intensifies. The revisions are in line with the evolution of price regulation plans elsewhere.

Qwest's proposal retains the basket structure of the existing plan and maintains the current assignment of services to the three baskets. It modifies the caps for the Basic/Essential Non-competitive Services and the Competitive Services Baskets. The plan introduces a new process for determining when a service can be moved out of the Basic/Essential Services Basket for purposes of grouping services offered by Qwest under price regulation. It provides for moving competitive wholesale offerings to a Basket 2 Competitive Sub-Basket. It also further streamlines the regulation of services in the Competitive Services Basket.

The renewed plan will give Qwest the ability to meet customers' needs and to respond to competitors in a timely manner and to rationalize rates for local services. For example, the plan will enable Qwest to do the following:

- Introduce innovative services and new packages without having to seek pre-approval from the Commission;
- Offer contracts tailored to customers' special needs and circumstances and make them available to similarly situated customers;
- Offer incentives to attract and retain customers quickly and without unnecessary regulatory review;
- Adjust retail prices to meet competition.

The renewed plan, the details for which are included in Attachment A, makes necessary changes based on Qwest's performance under price regulation since 2001 and the competitive environment faced by the Company in Arizona today.

2. PERFORMANCE

A. Productivity

The productivity factor used in the Settlement Agreement was based on an analysis of Qwest's historic Arizona productivity during a four-year period from 1995 to 1998. Using the same method incorporated in the calculation of the productivity factor used in the Settlement Agreement, Confidential Attachment B computes Qwest's average annual Arizona productivity during a four-year period from 1999 through 2002. A detailed discussion of Qwest's productivity can be found in Confidential Attachment C.

B. Earnings and Revenue Requirement

Confidential Attachment D is Qwest's preliminary separated results of operations for Arizona for 2002. The financial data upon which it relies are preliminary and subject to change to reflect ongoing audit adjustments and any future restatement of Qwest's financial statements.[1]

At line 26, Confidential Attachment D shows the net operating income from Qwest's results of operations. It shows at line 53 the intrastate average net investment during 2002. At line 36, it computes a return on average net investment for 2002.

Confidential Attachment E contains a statement of the aggregate investment and retirements in plant for the preceding calendar year and Confidential Attachment F provides the associated depreciation for the preceding calendar year.

C. Service Quality

Qwest continues its service quality improvements in Arizona since deploying the Price Cap Plan on April 1, 2001.

The Arizona Corporation Commission, in Decision No. 59421, imposed standards and penalties to Qwest in five Service Quality categories: Held Orders, Repair, Out of Service Within 24

[1] Attachment D is Qwest's standard "1990's" Report for Arizona. A 1990's Report is a report of the Company's actual results of operations as recorded on the Company's books. Qwest prepares the 1990's Report as a matter of course for all 14 states in which it operates on both the MR (FCC) and JR (state regulatory) bases of accounting. The report provided as Attachment D is the JR basis report for Arizona. The 2001 Settlement Agreement between Staff and Qwest in Docket No.T-01051B-99-0105 requires Qwest to include in this filing a "statement of the operating income and return on investment for the preceding calendar year." Accordingly, Attachment D includes no Arizona rate case adjustments, such as a directory revenue imputation. However, as ordered by the Arizona Corporation Commission in Decision 66230, Qwest will include $72 million of directory revenue imputation in any rate case adjusted results of operations or revenue requirement calculation filed with this Commission in this proceeding.

Hours, Access to Residential, Business and Repair Business Offices. Attachment G contains Service Quality results from January 2000 through May 2003.

Significant Service Quality Improvements Include:

1) Held Orders were substantially reduced to 3 in May 2003 compared to a high of 2,252 in August 2000.
2) Out of Service trouble reports cleared within 24 hours averages approximately 85% since Plan deployment, compared to 79% one year prior to the Plan.
3) Overall access to Residential, Business and Repair Business Offices improved and maintained satisfactory levels since the Plan was deployed.
4) As a result of the above-referenced improvements, there has been a significant decrease in the number of complaints submitted by Qwest customers to the Arizona Corporation Commission (see Attachment H). Complaints have decreased from a high 340 one year prior to the Plan to as low as 69 in April 2003.
5) The 4th Quarter 2002 Service Quality Report filed with the Arizona Corporation Commission is the first time Qwest reported all service quality measurements either met or exceeded the required standards; thus no penalty was assessed. So far in 2003, year-to-date results indicate no penalty accrual.

D. Price and Revenue Changes

Confidential Attachment I contains a detailed list of price and revenue changes made during the plan. Qwest reduced Basket 1 prices by $14.4 million on 4-1-02 and by $28.8 million on 4-1-03, as prescribed by the price cap index established for that basket. During the first year of the price cap plan, Qwest increased Basket 3 revenues by $42.7 million, as permitted under the price cap formula for that basket. On 4-1-02 Qwest reduced its Switched Access services in Basket 2 by $5.0 million and increased rates in Basket 3 by a similar amount. On 4-1-03, Qwest decreased Switched Access Service by an additional $5.0 million and increased Basket 3 rates by another $5.0 million. Qwest also reduced its PAL rates in Basket 2 by $198 thousand on 4-1-02.

3. COMPETITIVE ENVIRONMENT

There is substantial competition today in Arizona and it continues to intensify. In fact, approximately 25% of residential line losses within the 14-state Qwest region are in Arizona (in excess of 60,000 lines since January 2003). Qwest faces strong competition from both resellers and established facilities-based competitors, as well as from wireless carriers. In addition, Voice over Internet Protocol (VoIP) services are now readily available to Arizona retail customers as an alternative to Qwest's local exchange services.

The competitive landscape in Arizona has changed dramatically in the three years since the Price Cap Plan was adopted. The number of approved interconnection agreements has more than doubled.[2] CLEC activity in the local market has skyrocketed, as the following Qwest wholesale provisioning statistics demonstrate:

Product	**Apr-00**	**Apr-03**	**% Change**
Stand-Alone Unbundled Loops	9,033	37,329	313.25%
Unbundled Network Element Platform (UNE-P) Loops	0	56,195	NA
Local Interconnection Service (LIS) Trunks	82,034	183,896	124.17%
Total Ported Numbers (cumulative)	224,291	672,444	199.81%
CLEC End User White Page Listings	58,762	262,471	346.67%
Wholesale Resold Lines	21,919	10,386	-52.62%

Additional Competitive Data	**2000**	**2003**	**% Change**
Total Qwest Access Lines	2.9 million	2.6 million	-10.3%
Total Arizona Wireless Lines	2 million	2.8 million	40%

The decline in Wholesale Resold Lines, combined with an increase in the number of UNE-Platform Loops, reflects the natural evolution of CLEC competition from resale to facilities-based technology. Competitors such as Cox, McLeod, and MCI are now providing service to both residential and business customers in Phoenix over their own facilities or through the purchase of unbundled network elements from Qwest and are bundling local and long distance services into a single packaged offering.[3] Based on Cox's own data, it is now serving approximately 55,000 residential phone customers in Phoenix via its cable telephony facilities. Cox recently announced it is expanding its cable telephony offerings in the state by introducing local phone service in Tucson and Green Valley. According to Cox, 200,000 Tucson and Green Valley households will be able to obtain Cable, Internet, Local Phone Service and Long Distance Service combined on one bill. Three years ago, Cox was just entering the Phoenix market and was serving primarily business customers. AT&T has announced that it is doubling resources to the small business market in several key markets, including Phoenix.

[2] In December 2000, 65 interconnection agreements were in effect between Qwest and Arizona CLECs. As of April 30, 2003, the ACC had approved 143 interconnection agreements--83 wireline and 60 resale, wireless, paging, and EAS. Another 31 agreements (including wireline, resale, wireless, paging, and EAS agreements) were awaiting approval.

[3] It is not surprising that competitors have focused on the Phoenix market, as over half of the state's population resides in the Phoenix metropolitan area.

The most recent *Local Telephone Competition* report issued by the FCC on June 12, 2003 indicates that CLECs have captured 12% of the local market in Arizona.[4] According to this same report, CLEC share in Arizona stood at 5% in June of 2000. As CLECs' share in the market has increased, the number of Qwest retail access lines provisioned in Arizona has declined. In December 2000, Qwest was serving 2.9 million retail access lines in the state; by December, 2002, that number had dropped to 2.6 million.

The diversity of the current Arizona competitive market is also illustrated by the robust wireless competition present in the state. Wireless carriers, including T-Mobile, Verizon Wireless, Virgin Mobile, Cellular One, Sprint, Alltel, Nextel, and AT&T Wireless, offer an array of local and national plans at rates comparable to wireline service. Cricket Wireless offers residential customers unlimited local calling, similar to Qwest's unlimited wireline services, while the other wireless carriers offer significant blocks of usage (local and toll calling combined) for a fixed fee. In addition, wireless carriers typically offer popular calling features at no additional charge as part of their standard wireless package. As a result of the attractive calling plans and mobility associated with wireless service, consumers are increasingly substituting wireless service for wireline service. A nationwide survey released in May 2003 by Leap Wireless, the company offering service under the "Cricket" brand, found that 37 percent of Cricket customers do not have regular wireline phone service at home. This compares to 26 percent in June 2002. Cricket aggressively promotes its wireless service as a direct substitute for traditional wireline service.

Robust local exchange competition is now present in Arizona, and Qwest's competitors in this market are largely deregulated. It is appropriate that the regulatory standards for Qwest be revised to enable Qwest to compete more effectively and to have a better opportunity to earn a fair return on its investments in the state.

4. HIGHLIGHTS OF THE REVISED PRICE REGULATION PLAN

The major modifications Qwest is seeking in these revisions are:

1) Elimination of the productivity/inflation adjustment mechanism;
2) Replacement of an indexed basket cap on the Basic/Essential Services Basket with a newly determined revenue cap;
3) Introduction of a "Competitive Zone" test for moving services out of the Basic/Essential Services Basket on a geographic basis;
4) Ability to move wholesale services to a competitive sub-basket within Basket 2;

[4] Carriers serving less than 10,000 lines are not required by the FCC to report access lines in service, and are not included in this figure.

5) Elimination of the revenue cap on the Competitive Services Basket;
6) Greater flexibility for services in the Competitive Services Basket comparable to that enjoyed by Qwest's competitors: and
7) Opportunity to earn fair return on its investment, making appropriate prospective adjustments in light of results observed during the initial term of price cap regulation.

Each of these highlights is discussed briefly below.

5. REVENUE CAP FOR BASIC SERVICES BASKET

The current price regulation plan has an indexed cap (inflation less a productivity offset) on all services in the Basic Basket. It is in substantial part the operation of that cap and the overall reductions in rates that Qwest has had to implement (both here and in carrier access in the Wholesale Basket) that have significantly reduced revenue for the Company as discussed above (Section 2.D.). Qwest accepts these results and understands that they are risks associated with a price regulation plan, especially in a period of low inflation. However, Qwest cannot continue to bear that risk, especially when some of the services in the Basic Basket are priced below cost to begin with.

Therefore, Qwest proposes replacing the Basket 1 indexed cap with a newly determined revenue cap. Competition has substantially increased the risks faced by Qwest in the marketplace. As a result, attempting to gauge the appropriate rate of return for any service or basket of services—even indirectly or implicitly by means of a productivity offset—is much more problematic today than it was historically. In this respect, the proposed plan's elimination of a productivity offset is reasonable and marks a step closer to "pure" price regulation and away from traditional utility regulation. Qwest is willing to give up any inflation adjustment for the Basic Basket in return for additional flexibility in the pricing of services within the basket.

In addition, the proposed plan would remove the "hard caps" that Qwest agreed to in the current plan. Under the proposed plan, Qwest will be able to make appropriate "revenue-neutral" changes in prices for services in this basket with notice to the Commission but without prior approval. For changes that are not revenue-neutral, the Company must seek prior approval from the Commission.

6. COMPETITIVE ZONES

Qwest is proposing to introduce a standard for determining when services can be removed from the Basic Basket and shifted to the Competitive Services Basket on a geographic basis. In those wire centers where competition is demonstrably present, Qwest may petition the Commission to declare those wire centers a "Competitive Zone."

Qwest would be required to show that alternatives that are functionally equivalent to, or substitutes for, its offerings are readily available at competitive rates, terms and conditions in a particular wire center or group of wire centers. The showing is based on the existence of at least two competitors in that wire center or group of wire centers. These competitors can be either facilities-based providers (*e.g.* Cox) or providers utilizing unbundled network elements from Qwest (*e.g.*, McLeod). The standard that would be used in this price cap plan is consistent with the test embodied in R-14-2-1108 and would establish deadlines and procedures that enable Qwest to respond to competitors' offers in a timely manner. Qwest believes that this is a more appropriate test because it is simpler and more objective. Moreover, it is not being utilized to deregulate these services but rather to place them in the Competitive Services Basket where they can be offered in a manner that more closely reflects the way in which similar services are offered by Qwest's competitors in those wire centers. For example, Qwest would file a tariff that identifies the maximum rate for each service it offers in a Competitive Zone.

7. ABILITY TO MOVE WHOLESALE SERVICES TO A COMPETITIVE SUB-BASKET WITHIN BASKET 2

This provision remedies what Qwest believes was an important omission from the initial price regulation plan; *i.e.*, the ability to classify wholesale services as Competitive Services. There is no explicit provision for that in the current plan.

The change sought by Qwest would not vary the treatment of wholesale services. Each of them would continue to be governed by their own specific pricing rules. For example, there would be no effect on the availability or pricing of UNEs. However, Qwest would have the ability to seek Commission approval to move a wholesale offering to a Basket 2 Competitive Sub-Basket upon application by Qwest. For example, a service which has ceased to be a UNE may be moved to the Competitive Services Sub-Basket where the service might still be offered, but at a market rate rather than priced at TELRIC.

8. ELIMINATION OF THE REVENUE CAP FOR THE COMPETITIVE SERVICES BASKET

Qwest's experience to date under price regulation has demonstrated that there is no need for any cap on the Competitive Services Basket. Moreover, Qwest has been hurt by the assumption that revenue reductions taken on carrier access as agreed to under the existing plan would provide it with extra "headroom" in the Competitive Services Basket. In fact, Qwest has not been able to make up for these reductions even though it has priced Basket 3 up to the cap. Combined with the reductions forced by the indexed cap on the Basic Basket, Qwest's financial position has actually worsened since the inception of price regulation. Removal of the cap on the Competitive Services Basket will thus have no practical effect, but is another move in the direction of simplification of price regulation in Arizona. It will also eliminate the "illusion" that Qwest can somehow offset reductions elsewhere on the services that are competitive.

9. OPPORTUNITY TO EARN FAIR RETURN

Qwest proposes no rate changes in this filing. However, Qwest has not earned a reasonable rate of return during the first term of price regulation in Arizona and seeks to remedy that situation while also benefiting customers with this proposal.

Providing Qwest a reasonable opportunity to achieve a just and adequate return on the fair value of its rate base requires that it have a reasonable opportunity to recovery its revenue requirement. In a marketplace open to competition, revenue requirement will be recoverable only if rate setting takes competition into account. It would be unreasonable to assume that rate increases in Basket 3 services will allow Qwest to achieve its revenue requirement unless one also accounts for the loss of market share to competitors such rate increases would cause. After a three-year period of price caps in Basket 1, it is also reasonable to expect adjustments to inefficiently priced services.

Since Qwest has not earned a reasonable rate of return during the first term of price regulation in Arizona (Section 2), it seeks to remedy that situation while also benefiting customers with this proposal. The remedy involves a combination of increased flexibility, similar to our competitors, such as Competitive Zones treatment of rates where competition exists, maximum rates for Basket 3 Services, and placing all service packages and new services in Basket 3. In conjunction with increased flexibility, Qwest proposes a discussion with the parties which considers the determination of a new revenue cap for the basic services basket leading to the establishment of a Renewed Price Cap Plan. This new revenue cap for the basic services basket will allow Qwest an opportunity to adjust rates prior to the initiation of the Renewed Price Plan.

10. CONCLUSION

The purpose of this report was to provide a review and progress of the first Price Regulation Plan approved in Arizona. The intent was to give the Commission and Qwest an opportunity to refine the plan through on-going discussions, before continuing with another three-year term. Qwest seeks to renew the Price Cap Plan for another term with the modifications outlined in this report and Attachment A (Terms, Conditions and Operation of the Renewed Price Cap Plan). This plan combines additional opportunities for Qwest to compete in an ever-increasing competitive market.